SUMMARY of COOPERATIVE CASES

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UNITED STATES DEPARTMENT OF AGRICULTURE
FARMER COOPERATIVE SERVICE

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The comments on cases reviewed herein represent the personal opinion of the author and not necessarily the official views of the Department of Agriculture.

EXEMPT COOPERATIVES; PATRONAGE REFUNDS; EQUALITY OF TREATMENT; DEPARTMENTALIZATION AFTER CONSOLIDATION

The Chief of the Exempt Organizations Branch, Internal Revenue Service, has given an informal ruling that may be of interest to other cooperatives similarily situated. Two cooperatives were planning to consolidate but desired, for several years after the consolidation, to operate the physical properties in two separate divisions substantially as they were operated prior to consolidation. This ruling holds that payment of patronage refunds on a divisional basis under the circumstances outlined would not adversely affect the exempt status of the cooperatives.

The associations have consented to publication of this ruling with the letters "X" and "Y" substituted for the names of the associations involved and other identifying references eliminated. Except for these modifications, the ruling is set forth in full and is as follows:

"Reference is made to your recent request for advice as to whether certain proposed changes in the method of distributing patronage refunds will affect your present exempt status under section 521 of the Internal Revenue Code of 1954.

"According to the information furnished, you have been giving serious consideration for some time to devising a method of bringing four cooperatives including X Cooperative (hereinafter called X), under one management as a single cooperative, for the reasons outlined in your request. You have now advanced to the stage where discussions concerning this plan have been had with the board of directors of one of the cooperatives, namely, Y Cooperative (hereinafter called Y), which is also presently exempt from Federal income tax under section 521 of the 1954 Code. The plan so far contemplates that the assets of Y will be purchased and its liabilities assumed by X.

"After acquisition of the above-mentioned assets and liabilities by X, it is planned that the general overall administration of the combined operations will be conducted at the -- home office of X. However, immediately responsible to the top administration will be local managers of what will become known as the X and the Y Divisions of X. These divisions will share the burden of the top administration on a fair basis of apportionment.

"Each division would operate much as it does now as an individual company, except for such economies as can be introduced by assigning to either division, the responsibility for carrying on all of one type of a minor operation, rather than having both divisions carry on the same minor operations. Source of raw product will be an important consideration.

"It is anticipated that as a result of greater efficiency which can be achieved by the proposed method of operation, X, operating on such a divisional basis, will be able to market the products of its patrons more efficiently and effectively and will be able to hold its markets which are now seriously threatened by major nation-wide concerns. The end result sought to be achieved is to increase the final returns to the patrons of both divisions.

"With respect to the proposed method of distributing patronage refunds, you stated:

'(a) As a result of the acquisition of the assets of Y, and the proposed plan to operate the cooperative thereafter on the basis of two divisions - namely, the X Division and the Y Division, it is part of the contemplated plan of operation to distribute patronage refunds on a divisional basis, so that the patrons supplying agricultural products through the X Division will receive patronage refunds based on the net margins earned by that division, and the patrons supplying agricultural products through the Y Division will receive patronage refunds based on the net margins earned by the Y Division. This method of distributing patronage refunds would give recognition to historical earnings of margins by the two cooperatives. Over a five year period (1953-1957) X has averaged around ____% higher margins and savings overall than Y. Hence it is believed to be equitable that the patrons of the two divisions should continue to share the patronage refunds of their respective divisions until such time that efficiency of operations has become so generalized between the two divisions that the net margins have approached a level which represents fair equity if distributed across the board within the entire new X structure.

'(b) The process of getting from a basis of distributing patronage refunds on a divisional basis to one of distributing them across the board, company-wide, could be a

> gradual process. For example, it might be accomplished over a ten-year basis by making the patronage refunds distribution on the first year's operation wholly on a divisional basis. The second year, 10% of the total refunds could be made across the board and the balance on a divisional basis. The third year, 20% of the total refunds could be made across the board and the balance on a divisional basis. The fourth year, 30% of the total refunds could be made across the board and the balance on a divisional basis. The fifth year, 40% of the total refunds could be made across the board and the balance on a divisional basis. This would be carried on until 100% distribution is made across the board on the theory that at that time the difference in rate of net margins and savings between the divisions will have approached the point of relative insignificance.'

"You requested to be advised whether the distribution of patronage refunds on a divisional basis as outlined in (a) above will adversely affect the present exempt status of X. Also, you requested to be advised whether X's exempt status will be affected by the distribution of patronage refunds on a divisional basis, progressively moving toward a final across-the-board distribution of such refunds over a ten year basis as outlined in (b) above, giving due consideration to a fair apportionment of the overall administrative expenses, with each division standing its own operating expenses and direct administrative expenses.

"We believe that your proposed plan of distributing patronage refunds on a divisional basis following the merger of Y into X will not adversely affect the present exempt status of Y since it is apparent that such distribution is necessary to bring about the merger and it cannot be said that the patrons of either division will, in the beginning, stand in a different position insofar as the distribution of refunds is concerned. However, one of the basic requirements of section 521 of the Code is that strict equality of treatment of all patrons must exist with respect to the payment of patronage refunds. Therefore, although the divisional distribution of patronage refunds may, in the beginning, be justified to give recognition to the historical earnings of margins by the two cooperatives, you should, as the operations of the two divisions are combined and economies thus effected, change from a basis of distributing patronage refunds on a divisional basis to one of distributing the refunds across the board, company-wide.

"We are not in a position to judge how fast you should move toward a final across the board distribution in that your activities following merger will determine what economies are effected by combined operations, etc., changing the prior historical earnings of margins by the two cooperatives. We do believe, however, that you should adopt a final across the board distribution as soon as practicable for your own protection against any possible charge from patrons of either division that they are being discriminated against insofar as the payment of refunds are concerned. We would have no objection to the adoption of an across the board distribution at any time following the merger.

"It should be noted that no opinion is being expressed in this ruling concerning the effects of a merger upon your exempt status."

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EXEMPT COOPERATIVE; CUMULATIVE DIVIDENDS ON PREFERRED STOCK; PASSED DIVIDEND IN ONE YEAR CAN BE PAID IN SUBSEQUENT YEAR WITHOUT EXCEEDING STATUTORY MAXIMUM.

The exchange of letters quoted below in effect sustains the position taken by the cooperative that, since it was unable to pay a dividend in one year, it should not lose its exemption simply because it pays more than the statutory maximum in the following year provided the total of such payments does not exceed the aggregate maximum that might be paid for the total number of years in question. The correspondence has been edited only to delete identifying material. The final letter was issued by the Chief, Exempt Organizations Branch, Internal Revenue Service.

First letter from District Director's Office to the cooperative:

"Form 990-C for the fiscal year ending April 30, 1957, has been under investigation, and the following facts appear to warrant the recommendation contained in this letter.

"Line 1 of Schedule J-2 shows a dividend of $14,000.00 paid on capital stock. The balance sheet shows a capital stock outstanding as of the end of the year of $173,000.00. Thus, the

amount of dividends paid is greater than the amount permitted by the Internal Revenue Code.

"Section 521(b)(2) of the Internal Revenue Code states, in part: 'Exemption shall not be granted to any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of Incorporation or 8% per annum, whichever is greater on the value of the consideration for which the stock was issued ***.'

"It can be seen from the above that during the year in question a dividend was declared of greater than 8%, the maximum amount allowed by law, in order to still maintain an exempt status. Therefore, the recommendation is to be made to the National Office that your exempt status for this and subsequent years be revoked.

"You may, if you desire, file a brief in protest, and submit a request for a hearing in the National Office. Any such brief and request should be filed within 30 days from the date of this letter."

First reply by the cooperative:

" ______________________________ is a non-profit agricultural cooperative association. The Articles of Incorporation state that it was organized under "The Cooperative Marketing Law"-(citation).

"The Association submitted its corporate papers to the Commissioner of Internal Revenue in support of its request for a letter of exemption. Its Articles of Incorporation and its By-Laws provide for cumulative dividends of not to exceed six (6) percent per annum on its preferred stock.

"By letter dated _______________, the Association was notified:

> 'It is the opinion of this office, based upon the evidence presented, that you are exempt from Federal income tax under the provisions of section 101(12) of the Internal Revenue Code. . . .'

"The operations for the year ended April 30, 1951 resulted in a loss and the Association passed the dividend on its preferred stock. It was not able to begin to catch up on the passed dividend

on the preferred stock until during the year ended April 30, 1957. During that year one-half of the omitted cumulative dividend on the preferred stock was paid in addition to the regular dividend. It is the Association's belief that its action did not violate the terms of its letter of exemption since its payments of cumulative dividends have not been in excess of six (6) per cent per annum as provided in its corporate papers, when the 'per annum' designation is interpreted as applicable to the terms of issue of its cumulative preferred stock.

"In the event there is non-concurrence with the Association's point of view, in the light of the explanations made herein, we respectfully request a hearing in the National Office prior to final disposition."

Supplemental letter by cooperative:

"When we submitted the Protest dated ____________, we did not include a reference to FCS Bulletin 10, January 1958, published by the Farmer Cooperative Service, U. S. Department of Agriculture, Washington, D. C., under the title, "Legal Phases of Farmer Cooperatives." No doubt you have a copy of this bulletin. The penultimate paragraph on Page 200 of FCS Bulletin 10 reads as follows:

> 'It is understood that under the practice of the Internal Revenue Service, if an association is unable to pay a dividend in one year, there is no objection to the difference being made up in the next or succeeding years provided the amount of such payments does not exceed the aggregate that might be paid for the number of years in question.'

"It is our belief that the language quoted supports the position taken by the Association and as explained in the Protest dated ____________________."

Reply from Internal Revenue Service:

"We have had under consideration a recommendation from the District Director that your exempt status as a farmers' cooperative association be revoked.

"In a ruling dated ____________, we held that you were entitled to exemption from Federal income tax under section 101(12) of the Internal Revenue Code of 1939. Section 101(12) of the

1939 Code corresponds to section 521 of the 1954 Code.

"Based upon a careful review of the evidence presented in connection with the District Director's recommendation, it is our opinion that your exempt status should not be revoked. Accordingly, our ruling of ____________, is hereby affirmed and continued.

"You should continue to file Form 990-C annually with your District Director. This form may be obtained from the District Director and is required to be filed on or before the fifteenth day of the ninth month following the close of the taxable year.

"The District Director, ________________ is being advised of this action."

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DEFINITION OF GRAIN-STORAGE FACILITY FOR

ACCELERATED DEPRECIATION PURPOSES

(Rev. Rul. 59-238; I. R. B.1959-29 p. 6)

A public grain warehouse using a quonset hut type of building with portable grain elevating and handling equipment which is permanently available, comes within the definition of a "public grain warehouse" set forth in section 1.169-2(c) of the Income Tax Regulations, and, as such, qualifies for purposes of the amortization deduction provided in section 169 of the Internal Revenue Code of 1954.

Advice has been requested whether a quonset hut type of building, with portable grain elevating and handling equipment permanently available, qualifies as a grain storage facility for purposes of amortization deduction provided in section 169 of the Internal Revenue Code of 1954.

In general terms, section 169 of the Code allows a special sixty-month amortization deduction of the adjusted basis of grain storage facilities in lieu of depreciation if the facility

has been constructed, or reconstructed and completed after December 31, 1952, and on or before December 31, 1956. Section 169(d) of the Code provides in part, as follows:

> (d) DEFINITION OF GRAIN- STORAGE FACILITY.- For purposes of this section, the term "grain-storage facility" means -
>
> (1) any corn crib, grain bin, or grain elevator, or any similar structure suitable primarily for the storage of grain, which crib, bin, elevator, or structure is intended by the taxpayer at the time of his election to be used for the storage of grain produced by him (or, if the election is made by a partnership, produced by the members thereof); and
>
> (2) any public grain warehouse permanently equipped for receiving, elevating, conditioning, and loading out grain, * * *.

Section 1.169-2(c) of the Income Tax Regulations expands on section 169(d)(2) of the Code, stating in part, as follows:

> * * * A public grain warehouse must be a permanent structure, of either the elevator or so-called "flat storage" type, suitable primarily for the storage of grain, and the equivalent for receiving, elevating, conditioning, or loading out grain must be either permanently installed or permanently available for use. * * *

It is the position of the Internal Revenue Service that the term "flat storage" type, as used in section 1.169-2(c) of the regulations, was intended to include the quonset hut type of buildings.

Accordingly, it is held that a public grain warehouse using a quonset hut type of building, with portable grain elevating and handling equipment which is permanently available, comes within the definition of a "public grain warehouse" set forth in section 1.169-2(c) of the regulations and, as such, qualifies for purposes of the amortization deduction provided in section 169 of the Code.

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ADDITIONAL TAX COURT MEMORANDUM DECISIONS CITING AND FOLLOWING THE POMEROY CASE.

1. Alta Cooperative Elevator, T.C. Memo 1959-102; C.C.H. December 23, 602 (M) 18 T.C.M. 453.

2. Alta Cooperative Elevator, T.C. Memo. 1959-33; C.C.H. December 23, 468 (M), 18 T.C.M. 160.

3. Farmers Cooperative Elevator, T.C. Memo. 1959-30, C.C.H. December 23, 460(M), 18 T.C.M. 144.

4. Lone Rock Cooperative Exchange, T.C. Memo. 1959-21, C.C.H. December 23, 443 (M), 18 T.C.M.103.

5. Minburn Cooperative Exchange, T. C. Memo. 1959-18; C.C.H. December 23, 440(M), 18 T.C.M. 93.

6. Superior Cooperative Elevator Co., T.C. Memo. 1959-17; C.C.H. Dec. 23, 439 (M), 18 T.C.M. 90.

TIME WITHIN WHICH "NONEXEMPT" COOPERATIVES MUST MAKE ALLOCATIONS OF PATRONAGE REFUNDS.

(Rev.Rul. 59-322; I.R.B. 1959-40, p. -)

The Internal Revenue Service has clarified its interpretation of existing law on this subject through the release on September 16, 1959, of Rev. Rul. 59-322 in TIR-175. The official text of the ruling, which is scheduled to appear in Internal Revenue Bulletin 1959-40, dated October 5, 1959, reads as follows:

"In the case of nonexempt cooperatives, partronage dividends attributable to the patronage of any taxable year which are allocated to patrons in accordance with

a pre-existing obligation to so allocate may be excluded from the gross income of the cooperative for such taxable year if the allocations and notifications to individual patrons are made:

(1) For taxable years ending after December 31,, 1959, on or before the due date (including any extension of time) for filing the Federal income tax return of the cooperative for the taxable year in which the patronage occurred;

(2) For taxable years ending prior to January 1, 1960, within 8-1/2 months following the close of the taxable year in which the patronage occurred.

Advice has been requested concerning the time within which allocations of patronage dividends made after the close of the taxable year must be made in order to be excluded from the gross income of a nonexempt cooperative for such taxable year.

While the statute, section 522 of the Internal Revenue Code, in the case of exempt farmers' cooperative associations provides a period of 8-1/2 months following the close of the taxable year for the making of allocations and notifications to patrons of patronage dividends, no such statutory rules are provided in the case of nonexempt cooperatives.

It is the position of the Service that allocations and notifications of patronage dividends made pursuant to a pre-existing obligation by a nonexempt cooperative after the close of the taxable year in which such patronage occurred will be considered as made before the end of such taxable year if made on or before the due date for filing the Federal income tax return (including any extension of time) for the year in which such patronage occurred. Accordingly, such patronage dividends will be excluded from the income of the cooperative for that year.

However, in order to alleviate hardship resulting because of apparent widespread uncertainty as to the rules which should be followed, it is held that for taxable years ending prior to January 1, 1960, allocations and notifications of patronage dividends made pursuant to a pre-existing obligation by nonexempt cooperatives within a period ending 8-1/2 months after the close of the taxable year in which the patronage occurred (the same period allowed by statute in the case of exempt farmers' cooperatives) will be considered as made before the end of such taxable year."

This issue is involved in the case of Farmers Cooperative Co., Virginia, Neb. Dkt. No. 68952, in the Tax Court of the United States. Final briefs were filed on August 17, 1959. It is not known whether this ruling will have any effect on the pending case.

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AUTHORITY OF ASSOCIATION TO EXPEL MEMBER FOR BREACH OF MARKETING CONTRACT.

(Emidio Frezzo & Sons v. Delaware Mushroom Cooperative Association, 152 A.2d, 303 (Del.-1959))

The court held in this case that the Delaware statute providing for joint stock cooperative agricultural corporations does not authorize associations organized thereunder to adopt a bylaw providing for the dismissal of its members, even for cause. Accordingly, it held the defendant cooperative's bylaw on dismissal invalid.

The plaintiff was a family partnership doing business as Emidio Frezzo & Sons. The defendant, Delaware Mushroom Cooperative Association (hereinafter referred to as the "Association") was a cooperative organized under the Delaware laws providing for the creation of joint stock cooperative agricultural corporations.

It had been the policy of the Association to get from its members estimates of their proposed production so that a suitable marketing plan might be formed. For the years 1956 and 1957 the Board of Directors determined that each member should supply the Association 75% of his daily production of mushrooms. A mimeographed "Marketing Agreement" was signed by the members of the partnership agreeing to this arrangement.

In August 1956, the partnership of Frezzo & Sons notified the Association by letter that it had leased to Hillcrest Mushroom Farms, Inc., (hereinafter referrred to as "Hillcrest") 12 of its 14

double mushroom houses. The Association was informed that the production of the remaining two "doubles" would be available to the Association for the ensuing canning year. It was advised that since the partnership was no longer entitled to the production of the 12 leased "doubles" the partnership considered itself relieved of that part of its responsibility.

The Association contended that the partnership's leasing to Hillcrest was not in good faith, and, as a consequence, it had breached its Marketing Agreement. The partnership was advised by letter that failure to provide production of 14 double mushroom houses would result in punitive action. A meeting of the Board was held on February 11, 1957, to determine the action to be taken against plaintiff and, on February 12, the partnership was notified that its membership was terminated for its alleged misconduct. This action was taken pursuant to a bylaw which authorized the Board, by two-thirds vote, to terminate the membership of any person "for good cause", after an opportunity for hearing before the Board. Thereupon, plaintiffs instituted this action to enjoin the defendant Association from expelling plaintiffs and from refusing to accept the product from plaintiff's two remaining houses. A restraining order was obtained preventing the defendant from taking such action. Thereafter the parties filed stipulations of fact.

Plaintiffs stated the basic issue was whether the Board of Directors of the defendant Association had the power or authority to expel plaintiffs as common stockholders. The defendant stated the issue was whether the Board had the power or authority to terminate the membership of the plaintiffs. The court said that, since the members of the association must be stockholders, the difference in phrasing the issue was not material.

Plaintiff's counsel argued that the Marketing Contract was not a "rule, regulation, or order of the association", within the meaning of the bylaws, and thus the bylaw was inapplicable. The court, however, "assumed" that the Association's action was within the quoted terms of the bylaw. Plaintiff contended next that the bylaw was contrary to the Delaware public policy against the termination of a stockholder's rights as such. Again the court "assumed" that the bylaw did not run afoul of public policy. The court passed these issues because it considered the basic question was whether the bylaw, not being expressly authorized by statute,(which defendant conceded) was generally repugnant to the statute, as going beyond the intent of the legislature.

Following consideration of the various sections of the statute governing agricultural associations, the court found that not only had the legislature not granted the authority to adopt such a bylaw but by implication it had denied such a power. He pointed out that by clear language the legislature gave the right to adopt bylaws providing for the removal of directors. However, the right to adopt such a bylaw with respect to members is significantly absent, although he regarded such action "more 'radical' than the removal of a director or officer." The section dealing specifically with the right and responsibility of the Association to redeem or transfer stock makes no mention of "any redemption right in the event the member is removed for cause." Finally, the section dealing with marketing contracts (3 Del. C. §8511) "gives the association substantial, albeit discretionary, remedies against a recalcitrant member" but it "makes no mention of the right of removal."

The court pointed out that the Association had a remedy - to invoke §8511. But he concluded that the statute, fairly construed, prohibited the Association from adopting a bylaw providing for the dismissal of members, even for cause.

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